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The Crunch Hasn't Come—Yet

Available credit jumped last year. But 1984 is another story.

Federal borrowing—both on and off the budget—took a huge leap to $281 billion in 1983 from less than $200 billion the previous year. Yet there was no marked "crowding out" of private borrowers or severe upward pressure on interest rates because of a surprisingly strong 20% increase in available funds in the credit markets. But there's a great deal of risk that this lucky event won't repeat itself this year, which means the long-anticipated crunch may finally come. All of the big buyers of U.S. Treasury securities who bailed the economy out in 1983 are less able to do so in 1984, with the possible exception of savings and loan associations.

Commercial banks, which purchased a sizable 19.8% of the government offerings, are also the major source of consumer and commercial loans. Last year, corporations were cautious about borrowing, but attitudes may be different as the expansion proceeds. Consumers are already increasing their debt, and if companies follow suit, the federal government will face a great deal of competition it didn't have to contend with during 1983.

State and local governments are an even riskier source of funds this year. In 1983, they floated a large number of bond issues to get in under the wire of the new law requiring bonds to be registered and ended up with $30 billion in surplus funds. As a result, they were the third-largest buyers of treasuries, contributing 11.2% to the flow of funds that entered the credit market via this route. This year, however, municipalities and states will start spending their money on bridges, roads and other major projects. So inevitably, this source of funds will shrink significantly.

Foreign purchasers grabbed up a fair share of government securities as well, about 8% of the total. This is less than many people think (foreign cash has often been called the major cushion against crowding-out). Still, the amount of money foreigners contributed to U.S. credit markets doubled in 1983—a sizable sum that could dry up overnight due to a weakening dollar or a stronger-than-predicted worldwide recovery.

Savings and loan institutions, which sopped up 17.1% of treasuries last year, will probably provide about the same amount this year. These thrifts enjoyed a surge of money into their coffers when they were able to offer insured deposits at money-market rates. Many investors quickly switched their Individual Retirement Accounts into the S&Ls, and at the same time mortgage demand leveled off. But unless the IRA influx continues, the S&Ls will not be a source of great growth in available funds for borrowing.

In short, the U.S. is facing a year that will require about the same level of federal financing as 1983—if the budget estimates are correct. But this time around, most of last year's lifeboats are leaky—which is why the financial markets are worried more each day about the impact of the enormous federal deficit.

—JOSEPH W. DUNCAN

Joseph W. Duncan, formerly Chief Statistician of the Office of Management and Budget and Chairman of the United Nations Statistical Commission, is Corporate Economist of The Dun & Bradstreet Corp.

IT'S NOT JUST THE DEFICIT

The growth of federal borrowing is just as striking as the rapid increase in the federal deficit. Borrowing for on and off-budget items, including guaranteed loans and other government-sponsored activities, has soared since 1979.

FEDERAL SHARE OF THE CREDIT PIE (billions)

	1979	1980	1981	1982	1983
Federal borrowing from public	$33.6	$70.5	$79.3	$135.0	$212.3
Borrowing for guaranteed loans	25.2	31.6	28.0	20.9	34.1
Other government borrowing	21.9	21.4	34.8	43.8	34.6
Total money borrowed by federal government	80.7	123.5	142.1	199.7	281.0
Total money borrowed, public and private	423.5	356.4	414.3	394.2	497.5
Federal share of total	19.1%	34.7%	34.3%	50.7%	56.5%

Source: Federal Budget

Has Justice Killed Steel Comeback?

The antitrust challenge will cause serious problems, but specialization and massive outlays will make the industry competitive in the years ahead.

The antitrust bombshell tossed at the LTV-Republic Steel merger last month seemed at first glance to have blown up the entire American steel industry strategy for becoming lean enough and modern enough to compete with its tough and hungry international rivals. After all, mergers are a key element in that strategy, and the Justice Department was saying firmly that deals as ambitious as the one between LTV Corp. (parent of third-ranking Jones & Laughlin Steel) and fourth-ranking Republic Steel were out of the question. That hardly augured well for any merger between Number One producer U.S. Steel Corp. and Number Seven National Steel Corp., a proposal that provided the other big surprise announcement affecting the industry last month.

But while steel's best laid plans have suffered a setback, they are still viable. The industry's climb out of the competitive hole it helped dig for itself will be slower and more painful, but it will continue. And by 1990, the industry will look something like this:

■ The giant, integrated companies, which own their own coal and iron ore and produce virtually every kind of steel product, will be a thing of the past. Specialization will be the order of the day. "The supermarket days are gone," U.S. Steel Chairman David Roderick told DUN'S BUSINESS MONTH. "I don't think any U.S. producer will ever again offer a full product line."

■ The big firms will account for a far smaller percentage of the steel sold in the U.S. By 1990, the larger firms' share of the domestic market will decline from about 63% last year to about 50%. The rest will be evenly split between mini-mills and imports.

■ Virtually all of the antiquated facilities will have been closed, and heavy capital investments will have been made, so that the U.S. will have one of the most technologically advanced steel industries in the world.

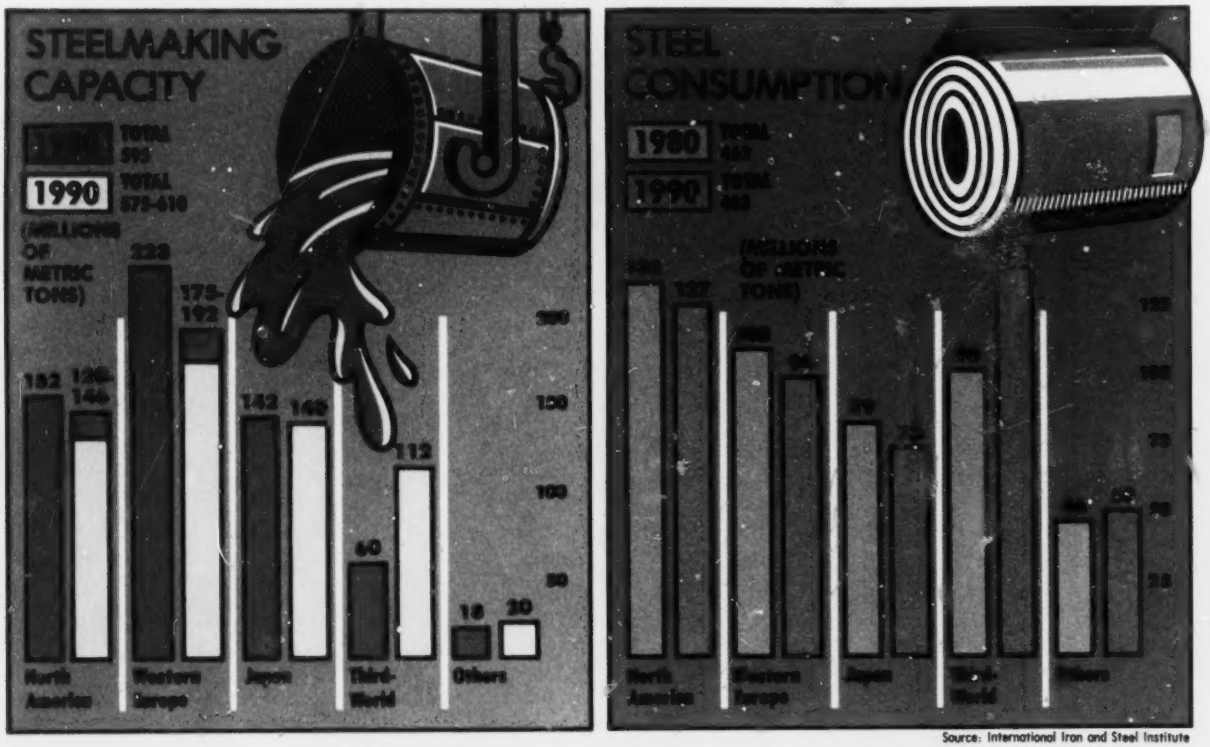
■ The pattern of feast or famine, huge profits in good times and heavy losses in bad, will have been broken. This will stem from far lower breakeven points as a result of technologically advanced mills.

Before the Justice Department moved against LTV-Republic, it appeared that the number of major steel companies would be reduced by mergers to three or four by 1990 versus eight today. Indeed, antitrust and steel industry experts believe that mergers are still possible, but with smaller firms, not among industry leaders *(see page 55)*.

Where mergers were not allowed, Antitrust Division chief J. Paul McGrath, who acknowledged that "the American steel industry is in a state of crisis," suggested other ways the companies might improve their prospects: "intercompany sales or exchanges of raw materials, fuel and semifinished products . . . reshuffling or consolidating plants and operations now under separate ownership." Achieving any of this, he added, might require "multiparty or industrywide negotiations." To even the most casual observer, this suggestion seems to open the door to possible collusion, a no-no in any Justice Department. McGrath recognizes that possibility, but offers to provide guidance in avoiding problems.

Whether it's really possible to keep the collusive nose from under the tent is open to question, but assuming it is, here are some of the alternatives to merger:

Joint ventures: Bethlehem Steel and Inland Steel announced one only in January. They will share technologies to develop electrogalvanizing methods to meet auto industry requirements. This is an R&D venture. But steel analysts can suggest a number of production arrangements. U.S. Steel has a mill in Gary, Indiana that produces semi-finished steel and National has a finishing plant in Portage, Indiana. The



Source: International Iron and Steel Institute

two could work together, with U.S. Steel supplying the semi-finished product that the National plant currently receives from other National plants in Granite City, Illinois and Ecorse, Michigan. "It would save $20 a ton in freight alone," says analyst David Healy of Drexel Burnham Lambert.

Intercompany sales or swaps for supplies: It's not uncommon for one company to buy slab from another. Other deals could be struck. For example, J&L has significantly cut back its commitments to buy iron ore, so it might buy supplies from Republic, which has an excess. However, some companies say they would be reluctant to make intercompany sales of products close to the final stage because the closer one gets to that stage the more information they would have to reveal about specifications, plant schedulings, customer needs and the like. Such information could be used competitively—or, ironically, it could also be used collusively.

Selling or swapping mills: Before LTV and Republic announced their proposed merger, industry observers speculated that LTV might be interested in selling some of its electric furnaces; a possible buyer, they said, was U.S. Steel. A major problem with this technique, of course, is that many of the mills that might be offered for sale or swap might not be the most modern.

Although McGrath didn't mention the possibility, other steel experts see another development in the aftermath of his antitrust decision: increased investment by foreign companies in American steel operations. The trend is already underway. In the most recent and widely publicized deal, Japan's Nisshin Steel Co. bought 10% of Wheeling-Pittsburgh Steel.

Whatever route the steel companies take, the restructuring will be slower and "a lot more painful," notes Robert Crandall of the Brookings Institution. "Companies that have merged are financially more capable of closing down facilities and taking write-offs than are the unhealthy companies or just one company on its own. They also have, together, more pieces of a puzzle to play with in determining what products, plants and processes they wish to keep and which ones they wish to close down or make more efficient."

While the major companies continue to cut their capacity in the years ahead, the small, non-union mini-mills, which have sprung up all over the nation over the past decade, will take a bigger bite of the steel business. The mini-mills, most of which can produce at least 500,000 tons of steel annually, use electric arc furnaces and can be built for between $300 and $400 per ton of annual capacity compared with $2,000 per ton for the larger facilities.

About 75-to-80 mini-mills are now being operated by about forty companies, and many more are planned. These mini-mills are capturing an increasing share of the bar, rod and wire business from both big U.S. and foreign firms, and they are now going after the structural steel market, where soft demand has caused some of the large firms to close facilities.

To tap the structural market, Chaparral Steel Co. has a 1-million-ton mill at Midlothian, Texas; Bayou Steel Corp. a 500,000-ton facility at La Place, La.; and Ohio River Steel Corp.

just brought onstream a 400,000 ton mill at Calvert, Kentucky. Given the average of just over 4 million-ton shipments a year during the past several years, this nearly 2 million added capacity could make the minis a major player in structural steel.

Moreover, the mini-mills have all but taken over the bar market. For example, they now hold 75% of the market for both rebars—small bars used to reinforce concrete—and bar-sized light structural steel. Between 1976 and 1980, average annual mini-mill shipments represented 13.8% of total U.S. steel shipments, with 11.8 million tons. It is estimated that their share of the U.S. market will rise to 25.1% by 1990 and 34.6% by the year 2000 *(chart, page 55)*.

The reasons for the mini-mills' spectacular success are many. Their labor cost per ton runs between $70 and $90, compared with $85-to-$175 for the unionized major steel firms. Because the mini-mills make only a few simple products, productivity is higher, as is capacity utilization, because production runs are longer.

Latecomers to the U.S. steel business, the mini-mills employ some of the most modern, sophisticated and efficient equipment and processes available, which further cuts production and labor costs. Mini-mills use scrap as their raw material, which costs less than the iron ore used by the big steel mills; the large mills are unable to switch to scrap because they are tied into long-term ore contracts. Energy costs run about $40 a ton for mini-mills compared with $90-to-$100 for the integrated mills, because these mills use the more fuel-efficient electric furnaces. Transportation costs are also lower, because the mini-mills are built closer to both the source of scrap and their customers.

As the mini-mills step up their capacity, the big integrated firms both in the U.S. and overseas are cutting back. This is largely due to forecasts of lackluster demand in the years ahead. Steel consumption by the non-Communist nations fell from 463 million metric tons in 1980 to 394 million metric tons last year, but will rise slightly to 418 million in 1984 and return to about the 1980 level the following year, according to estimates compiled by the General Secretariat of the International Iron and Steel Institute. By 1990, though, steel consumption for these nations will be only 483 million metric tons—with a 19 million ton decline in the industrialized nations offsetting a 39 million ton rise in the developing countries.

While worldwide steelmaking capacity is expected to drop, it will not be enough to offset the decline in demand. By 1990, the report estimates, the U.S., Western Europe and Japan will all have pared their capacity, but the developing nations will almost double theirs to 112 million metric tons. That means that while total non-Communist steel capacity will be between 575 and 610 million tons in 1990—hovering about the 1980 level of 595 million—demand will exist for only 483 million tons.

A number of factors account for this lackluster projected steel demand,

Who Makes What

The mini-mills now dominate such steel specialties as bar, wire and rod, while all the majors except Inland still make sheet.

Product	Domestic Shipments (1,000's of tons)	Imports (1,000's of tons)	U.S. Steel	Bethlehem	LTV	Armco	National	Republic	Inland	Wheeling-Pittsburgh	Mini-mills
Structural Steel	3,190	1,445	✓	✓	X	X	X	X	✓	X	moving into the junior-sized structural steel market
Bar	11,666	974	X	X	✓	X	X	✓	X	X	supplies an estimated 75% of the market
Plate	3,832	1,003	✓	✓	✓	X	X	X	✓	X	X
Wire	1,384	872	X	X	X	X	X	X	X	X	supplies an estimated 75% of the market
Sheet: cold-rolled	1,3781	2,417	✓	✓	✓	✓	✓	✓	X	X	X
hot-rolled	1,1619	2,317									
galvanized	6,434	1,824									
other	2,957	452									
Rail	633	108	X	✓	X	X	X	X	X	✓	X
Pipe and Tube	3,240	2,861	✓	X	✓	X	X	X	X	X	moving into pipe & tube market
Rod	2,886	1,185	X	X	X	X	X	X	X	X	supplies an estimated 75% of the market

A (✓) indicates the company makes the product, while an (X) indicates it does not. The figures are for 1983.

particularly in the U.S. Two of the biggest steel consumers—the auto and appliance industries—are using less steel and lighter steel products. A growing volume of finished industrial and consumer products, running the gamut from subway cars to wristwatches, is being imported into this country. These products quite obviously are made from foreign steel.

Moreover, while corporate capital spending is expected to increase in 1984 and 1985, a smaller percentage of the money spent by American firms will go for steel than in the past. U.S. firms will be purchasing productivity-enhancing equipment such as computers and electronic controls for their factory lines already in place.

The domestic steel industry has been in decline for almost forty years, ever since the end of World War II when its share of the non-U.S. market began declining as Japan and Europe rebuilt their industrial bases. The year 1959 was, in fact, the last in which the U.S. was a net exporter of steel. Since then, foreign steelmakers have taken bigger chunks of the world and U.S. markets. First the Europeans, then the Japanese and finally, in the late 1960s, the Third World began stepping up steel production. For instance, while worldwide production rose 35.7% from 1968 to 1978, Brazil saw its annual steel production nearly triple from 4,908,000 tons to 13,454,000 tons. Moreover, Brazil sold 292,683 of its 13,454,000 tons of steel in the U.S. By 1982, Brazil was selling 604,636 tons in the U.S., or 3.6% of total imports.

And 1983 was just a spectacular year for the Third World nations selling in the U.S. market. South Korea beat out West Germany for the Number Two spot—behind Number One Japan. During the first half of 1983, imports from Mexico rose 853%, Taiwan 40%, Brazil 33.8% and South Korea 26.4%, while imports from Japan fell 43.8% and from the EEC countries 45.2% from the year-earlier periods. In fact, imports from developing nations accounted for some 42% of all United States imports last year.

As Big Steel's Roderick Sees it

To obtain his views on a wide variety of issues affecting the steel industry, Midwest Editor Lynn Adkins spoke with U.S. Steel Chairman David M. Roderick in his baronial office in the company's Pittsburgh headquarters. Here is how the steel industry's top executive sees it:

■ *On the trade deficit:* When the Reagan Administration came into power the deficit was just about zero; it is going to be a $100 billion or more in 1984. The government has been remiss in not effectively dealing with the problem. If government is not responsible for its own currency value, then I don't know what the function of government is.

■ *On imports:* Nine out of ten tons of steel coming into this country today are being dumped. They are coming in below cost. Foreign governments are going to continue to sell those products at whatever price they can get because they have no need to make a profit. It is not even an objective for them. They are all price-fixers.

■ *On the high cost of modernization:* To replace 10% of U.S. Steel's capacity of about 30 million tons would cost about $6 billion. That is more than the $3 billion-to-$3.5 billion that our total stock is selling for.

■ *On U.S. Steel's retrenchment:* We have given up 90% of our capacity in the rod business and most of our less sophisticated bar business. We have cut the number of administrative people by 41% and our nonemployment administrative costs by 30%. We think we have things in place that are going to get us to about the 50% breakeven point.

To fight back, American steelmakers have been revamping the basic structures of their companies. According to most analysts and executives, the massive restructuring began in 1977, some eighteen years after the U.S. became a net importer of steel. Indeed, by 1984, the major American steel firms had lopped off some 25 million tons of capacity. Offsetting that has been the addition of between 10 million and 15 million tons by the mini-mills.

U.S. Steel will have reduced its capacity some 12 million tons, from 38 million tons in 1977 to about 26 million tons, when all the company's previously announced closings have been completed next month. During that same seven-year period, Bethlehem cut its capacity from 25 million to 17.5 million, reducing the number of blast furnaces it operates from 22 to 6, and National Steel halved its capacity to 6 million tons.

Other capacity reductions took place as a result of mergers. For example, when LTV's Jones & Laughlin steel unit merged with Youngstown in 1978, the move eliminated some 2 million tons of duplicate capacity.

Not only have the big firms scaled back their operations but they have selected specific segments of the market to serve, while abandoning other segments where they do not have a cost or technology advantage. "In the last five years, U.S. Steel, which had been by far the largest rod producer and the largest wire producer for literally decades, virtually got out of the wire business and gave up more than 2 million tons of rod capacity," says Roderick. "The competition from overseas and from the mini-mills was so severe and our costs were too high in relation to them."

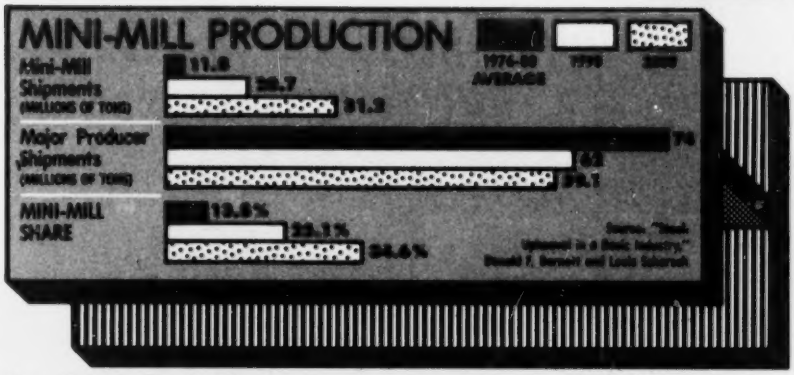
Thus, rather than being supermarkets, the nation's big steel companies are opting to become boutiques. To be sure, the major companies will maintain capacity to make basic steel, from which they manufacture their specialty products. Still, many have

formed, or are exploring, links with foreign steelmakers to obtain slab steel. U.S. Steel tried, but failed, to forge a link with British Steel for cheaper slab. Others have been more successful. Wheeling-Pittsburgh is in talks to buy slab from Brazil, following the lead of tiny Lukens Inc., which signed a long-term pact early last year to buy Brazilian slab. Analysts estimate Lukens is getting its slab for $40 per ton below what it could produce it for in the U.S. Ford Motors' Rouge Steel operation is buying slab from West Germany's Thyssen AG.

Both the developing and industrialized steel nations want to secure such links because it assures them an outlet for their product and serves as insurance if Congress votes further curbs on imports of finished steel.

As they scale back capacity, the nation's big steel firms are scrambling frantically to modernize their remaining plants. Continuous casting is the most frequent form of modernization. It is a more efficient method of casting that actually requires less steel. While about 95% of Japan's steel is continuously cast, only 55% of the U.S. industry will be using this method by 1986. The upgrading process will continue into the next decade.

On the labor front, the industry has extracted significant concessions from the United Steelworkers. Further concessions will be much harder to come by, though, as the firms begin to turn a profit and labor once again itches for a share of the prosperity. The shutdowns have permanently eliminated some 250,000 union jobs since 1977. The white-collar ranks have also been pruned by 96,000.



The result of all this slashing and reshaping will be a healthy level of profits, barring some unforeseen disaster such as another major worldwide recession. After amassing losses of more than $5 billion in 1982 and 1983, the nation's steelmakers are set to return to profitability this year and next. Some, such as National, turned the corner last year. Most in the industry will begin to report black ink in the next quarter.

But the profits turnaround will not be sustainable unless the industry further pares capacity by 10% by the end of the decade. U.S. Steel and Bethlehem will probably require another round of major shutdowns to eliminate some plate, bar and structural steel capacity. Inland and Republic may also be forced to close some of their capacity in these segments, but such shutdowns would be considerably smaller than those of the Big Two.

The wisdom of diversification is a hotly debated subject within and outside the industry. David Roderick staunchly defends his company's decision to plop down $6.3 billion to purchase Marathon Oil. He notes that the money for the acquisition came from U.S. Steel's non-steel operations, and was designed to give shareholders the best return on their money. Steel profits and cash flow should be used for the steel operations and non-steel profits, and cash flow should be plowed back into those businesses, in Roderick's view. "We have no intention of using Marathon's profits to finance the steel business," he says.

The ultimate success of the American steel industry's attempts to correct its past mistakes and pursue a new path to profits will depend on continuing the ongoing restructuring started in 1977. This includes plant shutdowns, mergers and specialization that must be accompanied by billions of dollars in capital investment. If the companies don't do all these things, the industry will resume its long-term decline. But most industry observers are betting that the steelmakers have learned their lesson the hard way and will do what has to be done. —LYNN ADKINS

Why Trustbusters Nixed the Deal

The major problems in the proposed LTV-Republic merger are carbon and alloy sheet and stainless sheet and strip. The combined companies would be the largest domestic producers of both, notes the Justice Department, with 22% of the carbon products and almost half the stainless.

The companies argue that imports should be considered when calculating market shares and degrees of concentration. But Justice excludes imports from countries that are subject to quotas. The department was saying in effect: you can have big mergers or quotas, but not both.

LTV, still interested in merging, is trying to see if it can accommodate the department's objections, but concludes that the task is "very difficult."

Steel industry mergers are still possible, according to antitrust specialist Robert Pitofsky, dean of the George Washington University Law School. But if a U.S. Steel or an LTV wants to merge, the other producer must be much smaller than Republic or National.

There's one other possibility—that the Antitrust Division, pressured by other Administration officials angry about the division's move, will modify its objections.

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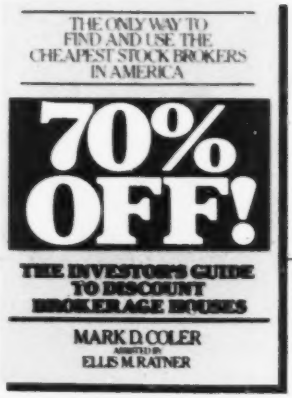
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INVESTMENT UPDATE

Here's the current status of a number of investments, and a look at how they have fared over the past month and the past year.

INVESTMENT	(1/31/84) Recent Price or Yield	Value of $10,000 if invested: Month Earlier	Year Earlier
Common Stock (Index fund, capital gains and dividends reinvested)	$19.60/share	$ 9,949	$11,669
per cent change		−5.1%	+16.6%
Bonds (30-yr., 11¾% Treasury Bond)			
MARKET VALUE	$99.94	$10,094	$ 9,667
ACCUMULATED INCOME		$ 98	$ 940
TOTAL		$10,192	$10,807
per cent change		+1.9%	+8.0%
Money Market Fund	8.80%	$10,074	$10,865
per cent change		+ 0.7%	+8.6%
Gold (Krugerrands)	$395.00/oz.	$ 9,777	$ 7,424
per cent change		−2.2%	−25.8%
HOUSE PRICES	**Recent**	**Month Earlier**	**Year Earlier**
Existing House	$82,400	$79,200	$80,500
per cent change		+4.9%	+ 2.6%
New House	$93,000	$94,800	$88,900
per cent change		−1.9%	+ 4.5%

Sources: Vanguard Group Inc.; Salomon Brothers; Donoghue's Money Fund Report; Deak-Perera Fifth Avenue, Inc.; Federal Home Loan Bank Board.

is a classic hidden asset play, according to McCabe. Its book value of $100 per share doesn't begin to record its 1.5 million acres of timber, 1 billion tons of coal and 39 barrels per share of proven oil reserves. He values Burlington Northern's assets at $150 per share, minimum. In contrast, the stock recently traded at 89. Meanwhile, the company is enjoying sharply improved returns on equity. From a low of 5.8% in 1978, Burlington Northern's ROE rose to 10.5% last year and could approach 13% this year, according to Banker's Trust. Such a performance would produce an earnings gain of 36% this year.

"Most investors buy auto stocks in the early stages of recovery and sell them now, but we think that the cash flow generation and reinvestment rates for Ford Motor Co. and General Motors Corp. will stagger the average auto analyst," McCabe says. Bankers Trust estimates that GM's earnings per share will climb from $11.86 last year to $17.50 this year and $20.50 in 1985. And cash flow will grow more: from $28 a share last year to $34.50 this year and $38.50 next year. Stockholders' equity will also rise from $62 a share in 1983 to $95.50 in 1985, according to Bankers Trust's projections.

Ford Motor will similarly see earnings soar from $9.50 per share in 1983 to $17 a share in 1985 and cash flow per share jump from $22.30 last year to $32 in 1985, according to McCabe. He believes that current prices of GM and Ford common stock don't reflect these prospects.

U.S. Steel is a hybrid company, oil and steel, but it is undeservedly out of favor with portfolio managers because it is viewed as a steel company, according to McCabe. But he sees it as an oil company, noting that Marathon Oil produces the larger part of its earnings. He also believes that Big Steel's ROE will swing from negative to better-than-average. He projects an ROE of 13.2% this year and 18.1% in 1985. —A.H.